Equity Market Review and Outlook

By Richard Skaggs, CFA, VP, Senior Equity Strategist

KEY TAKEAWAYS

- While second-quarter equity performance was restrained, we believe the equity bull market is on firm footing.
- This bull celebrated its sixth birthday—quite a long stretch of relatively low volatility and persistent gains.
- We prefer the current steady ascent in equity prices to a potentially unsustainable advance accompanied by heightened valuation risk.

Global equities eked out a positive quarter, although late-quarter weakness tied to Greece dragged down returns. Earnings in the US, Europe and Japan are positive, with Europe showing some of the strongest quarterly growth this cycle. Weakness in energy sector earnings remains a drag, but most other sectors continue to perform well. The struggle for top-line growth together with low borrowing rates and healthy capital markets is propelling mergers and acquisition (M&A) activity worldwide.

Another Positive Quarter for Global Equities (Barely!)

Global equities were broadly on track for respectable gains until volatility related to Greece upset the apple cart, causing global equities to finish just above the zero line. Year-to-date equity performance continues to be healthy, led by Japan and Europe. The US is up modestly following strong 2014 performance. Policy steps by the European Central Bank (ECB) have boosted confidence, and European economic data, Greece notwithstanding, have taken a turn for the better. Japanese stocks continue to perform well as corporate reforms have led to very early signs of a more pro-shareholder orientation and better financial returns. Emerging market (EM) equities had a mixed showing this year, with challenges in Latin America, particularly Brazil, weighing on performance. Chinese stocks were exceptionally volatile on the upside and the downside during the first half.

A Second-Half Growth Pickup—Along with a Fed Rate Hike?

US data was on the softer side early this year, with first-quarter GDP about unchanged. With stronger data recently, we anticipate a better second half, similar to 2014. Employment growth remains a strong positive for the US outlook, and wages are beginning to pick up. Long-term interest rates have risen somewhat in recent months but are still at very low levels and quite attractive for companies arranging financing. We continue to expect the Federal Reserve (the Fed) to raise the federal funds rate this year, reversing near-zero policy rates that have been in place since 2008.

While investor nervousness around first rate increases is understandable, history suggests stocks continue to perform well, on average, in the months following an initial hike. Rate hikes typically indicate policymaker confidence in the medium-term outlook. Inflation remains well within stated target ranges, under 2.0% annually. There is potential for the US dollar to strengthen further in the event of one or more rate hikes, a key concern. The dollar has risen in value versus most currencies over the past year, with a pause in the second quarter. Revenue and earnings growth for some US multinationals has been challenged when translated back into dollars.

Earnings Outside of the Energy Sector Remain Healthy

Generalized weakness in commodity prices, especially oil, is another consequence of the stronger dollar. S&P 500® Index earnings growth outside the energy sector continued to be healthy, with the median company posting 7% year-over-year operating earnings growth in the first quarter of 2015. However, given the dramatic decline in energy sector earnings, index aggregate earnings were up just nominally. Energy sector earnings fell more than 50% due to lower commodity prices, and we expect energy to be a drag on index earnings throughout 2015. Europe appears similarly impacted.

On the other hand, healthcare earnings growth has continued to be strong, in the mid-teens, while technology and financials each posted earnings growth in the high single digits. So far this year, healthcare, especially biotechnology, has been the hands-down performance leader, while commodity-sensitive sectors, such as energy, basic materials and transportation stocks, have notably lagged.

The Global Bull Remains on Firm Footing

While equity performance in the second quarter was restrained, our outlook for the months ahead is positive. Regional growth prospects are showing signs of improvement, lower commodity prices are capping global inflation expectations, and long-term interest rates are expected to remain low even if the Fed hikes later this year. We believe there are few alternatives to equities for investors seeking potential returns in the mid to high single-digit range over a full market cycle.

The S&P 500's dividend yield has remained around 2% for many years, as dividend increases have generally kept pace with higher equity prices. S&P 500 dividends are on pace to grow 8% to 10% in 2015, even when building in lower dividend growth from the energy sector. In Europe, dividend yields are tracking above 3%, although share repurchases are not widely implemented compared with the US. Japanese companies are focused on capital return strategies as well, and that country appears to be in the early stages of a multi-year cycle of improving corporate return on equity.

Growing shareholder activism and continued M&A activity are two more positives for stocks. According to Bloomberg, global announced M&A in the first half of 2015 is running at a pace more than 30% above the same period in 2014. Activity is balanced across regions and sectors. At the prior peak of M&A activity back in 2007, transactions were heavily weighted in the finance sector, and many of these combinations did not turn out well. With cash earning close to zero and a challenging revenue growth environment, we see more managements worldwide pursing business combinations as a way of building shareholder value.

While equity valuations have improved, they are far from excessive in most markets relative to interest rates and business fundamentals. In fact, the recent quarter of flattish performance has given stocks some time to “catch up” with an improving earnings outlook later this year and into 2016. For example, the S&P 500 is now valued at about 16.0x estimated 2016 operating earnings. Of course, earnings have to materialize in the quarters ahead to justify this valuation, but we believe earnings risk appears limited, presuming growth continues and a recession is avoided. Profit margins are edging higher in both Europe and Japan. Although we do not expect significant expansion from here, margins in the US should hold around current high levels (save weakness in energy).

We prefer the current environment’s steady ascent in equity prices to a potentially unsustainable advance accompanied by heightened valuation risk and potential disappointment. The usual risks remain, of course. Reversing global economic fundamentals, commodity price swings and potential US rate increases could lead to higher volatility. Greece is a current concern, and the situation could play out many ways. But regardless of the outcome, Greece should not materially alter global equity market fundamentals beyond creating some choppy markets here and there. Geopolitical risk, as always, remains a wild card that cannot be explicitly factored in.

Moderate stock price corrections should provide selective buying opportunities, much as they have for the better part of the past six years. Positive equity performance outside the US suggests a broadening of equity investment opportunities, a certainly welcome development.

Second Quarter Review

GLOBAL EQUITY MARKETS
as of June 30, 2015

INDEX TOTAL RETURNS (%)

INDEX	3 MO	YTD	1 YEAR	3 YEAR	5 YEAR	10 YEAR
S&P 500®	0.28	1.23	7.42	17.31	17.34	7.89
MSCI ALL COUNTRY WORLD	0.52	2.97	1.23	13.61	12.52	6.97
MSCI EUROPE	0.68	4.28	-7.17	12.99	10.67	5.64
MSCI JAPAN	3.12	13.79	8.63	13.56	9.03	4.39
MSCI EMERGING MARKETS	0.82	3.12	-4.77	4.08	4.03	8.46

Global indices were poised for solid quarterly returns; however, developments in Greece resulted in low to mid single-digit declines in the final week of the quarter. We believe issues with Greece will have transitory effects on global equities, although stretches of volatility would not be surprising given the considerable uncertainty.

Even with the volatility, the S&P 500 posted a nominal gain after adding back dividends (results were down fractionally on a price-only basis). This was the tenth consecutive quarter of positive total returns. Only four negative-return quarters have occurred since March 2009, and the last correction of 10% or more concluded in 2011. Now one of the longer periods without an intervening bear market, this bull celebrated its sixth birthday.

Global indices also posted modest gains. The MSCI All Country World, weighted approximately 50% US and 50% rest of the world, eked out a fractional gain. Year to date, the performance edge of Europe and Japan is clear as policy actions by regional central banks have boosted confidence, and corporate earnings have improved. In Japan, we expect the more than two-year earnings upswing to continue. In Europe, the first quarter marked a positive inflection in corporate earnings. European profits have been mostly flat since the financial crisis ended. However, a number of positives such as central bank intervention, lower interest rates, and a weaker euro have contributed to an improving earnings outlook, particularly in Germany. It is early yet, but we think the outlook for Europe and Japan in the second half of 2015 and into 2016 is constructive, challenges with Greece notwithstanding.

EM equities were also slightly higher for the quarter and up for the year. While China has been extremely volatile, it is the Hong Kong listed, and reasonably valued, China "H" shares that dominate the weightings within popular emerging market indices. Even with the dramatic selloff in recent weeks, China equities gained for the quarter and were up nicely for the year. We remain concerned the speculative bull market in many mainland emerging growth companies will be a source of substantial volatility.

The US dollar peaked against most currencies in late March, which took pressure off global equity returns when translated back to dollars. The strong dollar over the past 12 months contributed to EM equities' -4.8% return for the same period. The modestly weaker dollar versus the euro in the second quarter also contributed to the positive return from European equities, as local currency returns were modestly lower before translation back to dollars.

US EQUITY MARKETS
as of June 30, 2015

INDEX TOTAL RETURNS (%)

INDEX	3 MO	YTD	1 YEAR	3 YEAR	5 YEAR	10 YEAR
RUSSELL 1000®	0.11	1.71	7.37	17.73	17.58	8.13
GROWTH	0.12	3.96	10.56	17.99	18.59	9.10
VALUE	0.11	-0.61	4.13	17.34	16.50	7.05
RUSSELL MIDCAP®	-1.54	2.35	6.63	19.26	18.23	9.40
GROWTH	-1.14	4.18	9.45	19.24	18.69	9.69
VALUE	-1.97	0.41	3.67	19.13	17.73	8.89
RUSSELL 2000®	0.42	4.75	6.49	17.81	17.08	8.40
GROWTH	1.98	8.74	12.34	20.11	19.33	9.86
VALUE	-1.20	0.76	0.78	15.50	14.81	6.87

Data Source: FactSet. All returns quoted in US dollars. Performance for one and multi-year periods is annualized. ***Past performance is no guarantee of future results.***

Among large caps, the growth and value competition was a standoff this quarter, but growth won out year to date and over the past 12 months. In mid and small caps, growth generated more significant outperformance.

Growth's leadership is directly attributed to relative sector weights, as typical growth sectors continue to do well. Healthcare, especially biotechnology, and information technology have been outperforming. Commodity-sensitive sectors like energy and materials continue to languish under lower oil prices and concerns over commodity demand.

Interest rates rose in the quarter, with the 10-year Treasury yield tacking on about 35 basis points. Many investors anticipated higher interest rates over the medium term, as the Fed continues to prepare markets for a 2015 rate increase. Interest rate-sensitive stocks, such as utilities and real estate investment trusts (REITs), have come under pressure, and these sectors are more heavily weighted in value indices.

S&P 500 SECTORS
as of June 30, 2015

SECTOR PERFORMANCE ATTRIBUTION (%)					
INDEX	3 MO	YTD	1 YEAR	3 YEAR	5 YEAR
HEALTHCARE	2.84	9.56	24.18	27.42	23.79
CONSUMER DISCRETIONARY	1.92	6.81	16.46	22.53	23.33
FINANCIALS	1.73	-0.36	9.33	20.98	14.17
TELECOMMUNICATIONS	1.59	3.15	1.89	6.32	14.08
INFORMATION TECHNOLOGY	0.18	0.76	11.10	15.83	17.35
MATERIALS	-0.48	0.50	-1.08	13.42	14.40
CONSUMER STAPLES	-1.74	-0.77	9.41	14.04	16.54
ENERGY	-1.88	-4.68	-22.20	5.62	10.56
INDUSTRIALS	-2.23	-3.06	2.39	17.26	16.90
UTILITIES	-5.80	-10.67	-2.90	8.05	12.50
TOTAL RETURN	0.28	1.23	7.42	17.31	17.34

RUSSELL 2000 SECTORS
as of June 30, 2015

SECTOR PERFORMANCE ATTRIBUTION (%)					
INDEX	3 MO	YTD	1 YEAR	3 YEAR	5 YEAR
HEALTHCARE	5.76	18.85	35.01	27.54	25.27
INFORMATION TECHNOLOGY	1.84	7.43	13.44	20.66	18.82
FINANCIALS	0.39	2.00	7.76	16.22	15.07
CONSUMER DISCRETIONARY	-0.34	4.82	9.15	19.78	18.33
TELECOMMUNICATIONS	-0.39	-1.00	0.31	11.61	11.70
ENERGY	-1.28	-1.89	-46.44	-4.53	1.63
CONSUMER STAPLES	-1.43	-1.12	7.95	18.01	18.13
INDUSTRIALS	-2.19	0.35	-0.89	17.62	16.26
MATERIALS	-5.02	-4.55	-10.44	10.80	12.44
UTILITIES	-7.01	-6.01	-1.36	11.60	14.22
TOTAL RETURN	0.42	4.75	6.49	17.81	17.08

Healthcare continues to be the top-performing sector across market capitalizations domestically and worldwide, driven by pipeline innovation, M&A activity and the sector's generally non-cyclical business profile. The three- and five-year annualized returns are striking at well over 20% annually. But healthcare is not alone in its outperformance; both consumer discretionary and information technology have also been consistent innovators and outperformers over time.

Financial stocks outperformed in the second quarter. Within financials, banking and brokerage stocks performed very well. While partially due to lagging performance in recent periods, banks may be one of the groups to benefit directly from a shift to higher Fed policy rates. Net interest margins at banks have been under relentless pressure in this near-zero interest rate policy regime. A gentle rise in rates will materially enhance banks' reinvestment opportunities, particularly if associated with healthy loan demand and still near-pristine credit quality. On the other hand, REITs performed poorly in the first half, so stock picking within the financial sector provided significant opportunities in recent months.

Not surprisingly, utility, energy and material stocks were lower across the market cap spectrum. While energy shares performed better than in the extremely negative second half of 2014, near-term catalysts for materially higher oil prices are few. Of course, forecasting the price of oil often meets with a low success rate, but for now the world appears amply supplied, unless geopolitical developments cause an abrupt change in supply/demand dynamics. Earnings have been very poor across the energy sector, and we do not expect a return to positive comparisons until some time next year.

Data Source: FactSet. All returns quoted in US dollars. Performance for one and multi-year periods is annualized. Sorted by respective index quarterly returns. Due to rounding, sector totals may not equal 100%. ***Past performance is no guarantee of future results.***

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Disclosure

All data as of June 30, 2015, unless otherwise noted.

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Standard & Poor's (S&P 500®) Index *is a market capitalization-weighted Index of 500 common stocks chosen for market size, liquidity, and industry group representation to measure broad US equity performance. S&P 500® is a registered service mark of McGraw-Hill Companies, Inc.*

MSCI All Country World *is a market cap weighted index of stocks from developed and emerging markets providing a broad measure of global equity-market performance.*

MSCI Europe *is a free float-adjusted market cap index measuring equity market performance of the large and mid cap segments across European developed markets.*

MSCI Japan *is a free float-adjusted market cap index measuring equity market performance of the large and mid cap segments of the Japanese market.*

MSCI Emerging Markets Index *is a free float-adjusted market cap index measuring equity market performance of emerging markets.*

Russell 1000® Index *measures the performance of the large cap segment of the US equity universe. It is a subset of the Russell 3000 Index and includes approximately 1000 of the largest securities based on a combination of their market cap and current index membership.*

Russell 1000® Growth Index *measures the performance of the large cap growth segment of the US equity universe. It includes those Russell 1000 Index companies with higher price-to-book ratios and higher forecasted growth values.*

Russell 1000® Value Index *measures the performance of the large cap value segment of the US equity universe. It includes those Russell 1000 Index companies with lower price-to-book ratios and lower expected growth values.*

Russell Midcap® Index *measures the performance of the mid cap segment of the US equity universe. The Russell Midcap is a subset of the Russell 1000 Index. It includes approximately 800 of the smallest securities based on a combination of their market cap and current index membership.*

Russell Midcap® Growth Index *measures the performance of the mid cap growth segment of the US equity universe. It includes those Russell Midcap Index companies with higher price-to-book ratios and higher forecasted growth values.*

Russell Midcap® Value Index *measures the performance of the mid cap value segment of the US equity universe. It includes those Russell Midcap Index companies with lower price-to-book ratios and lower forecasted growth values.*

Russell 2000® Index *measures the performance of the small cap segment of the US equity universe. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.*

Russell 2000® Growth Index *measures the performance of the small cap growth segment of the US equity universe. It includes those Russell 2000 Index companies with higher price-to-value ratios and higher forecasted growth values.*

Russell 2000® Value Index *measures the performance of small cap value segment of the US equity universe. It includes those Russell 2000 Index companies with lower price-to-book ratios and lower forecasted growth values.*